ESRB
European Systemic Risk Board
European System of Financial Supervision

Assessment of a risk-weight adjustment for exposures secured by mortgages on commercial immovable property in accordance with Article 124 of the Capital Requirements Regulation in Latvia

Introduction

On 17 November 2023 Latvijas Banka notified the European Systemic Risk Board (ESRB) of its decision to adjust the higher risk weights previously set for exposures secured by mortgages on commercial immovable properties (commercial real estate (CRE) exposures) for banks using the standardised approach (SA banks), in accordance with Article 124(2) of the Capital Requirements Regulation (CRR).[1] A higher risk weight of 100% for CRE exposures was introduced in 2007 in Latvia. Latvijas Banka now intends to adjust the risk weight for CRE exposures to 80% from 30 June 2024. Ultimately, a higher risk weight in accordance with Article 124(2) of the CRR should continue to apply for CRE exposures of SA banks compared with the 50% risk weight set out in Article 126(1) of the CRR for these exposures.

Pursuant to Article 124(2) of the CRR, the ESRB is required to provide its opinion on the measure to Latvia within one month of receiving the notification. The procedural framework for issuing opinions under Article 124 of the CRR is clarified in Decision ESRB/2015/4.[2]

The ESRB's assessment draws on information provided by Latvijas Banka and discussions within the Assessment Team and with staff of Latvijas Banka.

1. Description of the proposed measure

The proposed measure consists of an adjustment to the higher risk weight already applicable to CRE exposures of SA banks pursuant to Article 124 of the CRR. A risk weight for CRE exposures that is higher than the one set out in Article 126(1) of the CRR has been in force since 2007. Latvijas Banka now intends to adjust the risk weight for CRE exposures from the currently applicable 100% to 80%. Ultimately, a higher risk weight that is in line with Article 124(2) of the CRR should continue to apply for CRE exposures of SA banks, compared with the 50% risk weight set out in Article 126(1) of the CRR for these exposures. However, it will be reduced in comparison to the level currently in force in Latvia. The 80% risk weight will be applicable from 30 June 2024 and has no expiry

[1] See Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

[2] Decision of the European Systemic Risk Board of 16 December 2015 on a coordination framework for the notification of national macroprudential policy measures by relevant authorities, the issuing of opinions and recommendations by the ESRB, and repealing Decision ESRB/2014/2 (ESRB/2015/4), as amended by Decision ESRB/2021/7.

date; however, Latvijas Banja will monitor the relevant data annually, and the risk weight calibration will be reviewed as appropriate.

The impact of the application of the lowered risk weight by the banking sector will be gradual, as currently the majority of credit institutions do not classify their CRE exposures as exposures fully and completely secured by mortgages on commercial immovable property. Currently, most banks classify their CRE exposures as corporate exposures, not taking into account the collateral of the loan. Corporate exposures for which a credit assessment by an external credit assessment institution is not available (which is the case for most companies in Latvia) are assigned a 100% risk weight,[3] the same as the higher risk weight that has applied to CRE exposures since 2007. Lowering the applicable risk weight from 100% to 80% will also provide credit institutions with an incentive to evaluate whether exposures in their commercial property loan portfolios conform to the applicable criteria and can be classified as fully and completely secured by mortgages on commercial immovable property, which might take up to a year to finalise for those banks that decide to do so based on the estimation of Latvijas Banka. The correct classification of loans is important to properly monitor risks inherent in these exposures, which may differ from the risks in other corporate exposures.

2. Analysis of the underlying systemic risks

The risks associated with the Latvian CRE market have changed significantly since the introduction of the 100% risk weight for CRE exposures. The risk weight was originally set at 100% in 2007 due to the small size of the local CRE market, which makes this market less liquid and potentially subjects CRE exposures to higher losses and longer recovery periods for credit institutions in case of foreclosure. While this rationale is still relevant, market liquidity has generally improved according to the assessment of Latvijas Banka, and loss rates decreased compared with the period of the global financial crisis and its aftermath. After the financial crisis of 2007-08, banks have become more cautious and conservative in their lending practices and risk management, which can be seen in more prudent lending standards and portfolio quality. However, there is still a high amount of uncertainty present in the current macro-financial environment, including as regards possible future ramifications and structural changes in the CRE market because of the effects of the pandemic and changes in the global interest rate environment.

Available data on loss experience at the current juncture are of limited value, as the relevant COREP reporting framework (template C 15.00) does not cover a full financial cycle and contains data only for a few credit institutions. As most exposures are not classified as exposures fully and completely secured by mortgages on commercial immovable property, the supervisory reporting provides only a limited value for the loss experience analysis. Therefore, Latvijas Banka also employed data from the national credit register, where granular information is available for each exposure. Based on available supervisory data on a wider exposure subset of all loans to Latvian residents collateralised by commercial immovable property, non-performing loan ratios are much

[3] Article 122(2) of the CRR.

lower than in the period between 2016 and 2019, which suggests that the credit quality of underlying exposures has improved in recent years, especially in the case of SA banks. Latvijas Banka's analysis of granular exposure data in the national credit register also supports this narrative of an overall decreasing but still heightened risk of exposures that could potentially be classified as fully and completely secured by mortgages on commercial immovable property. Latvijas Banka estimates that such exposures held by two credit institutions that use an internal ratings based (IRB) approach for calculating credit risk capital requirements (IRB banks) tend to be of a slightly higher credit quality than those of SA banks. This is consistent with the fact that implied risk weights for the exposures in IRB banks' loan portfolios are also on average slightly lower than the 80% risk weight that is going to be set for SA banks.

CRE prices in Latvia have been slowly decreasing lately, but a severe market downturn is deemed unlikely. As for the development of CRE prices, information is given by the index of CRE value for various segments in the capital city, which is calculated by Latvijas Banka and accounts for the majority of the total exposures. A significant negative fluctuation is observed around the period of the global financial crisis and its aftermath in 2007-09. The volatility has since decreased, except for the recent years affected by the pandemic. Prices have been decreasing lately in all CRE segments, though currently there is comparatively low activity in the CRE market, which slightly hinders price discovery. While Latvijas Banka sees potential for a further price correction as the economic actors continue to adjust to the changed interest rate environment, a severe market downturn is unlikely, as the price growth in the years since the global financial crisis has been moderate overall. Nevertheless, as it takes some time for the effects of price changes to fully manifest themselves in credit institution balance sheets, continuous monitoring of the situation is needed.

Although CRE loans have only shown limited growth in recent years, they constitute a significant share of local lending. As of end-2022, credit institutions (including branches of credit institutions registered in other EU Member States) had issued €3.3 billion in loans to Latvian residents collateralised by commercial immovable property, of which SA banks issued €1.6 billion. This represents 53% and 54% of the total resident non-financial corporations loan portfolio for all banks and SA banks respectively. Latvijas Banka's estimations, which are based on the analysis of national credit register data, suggest that out of that €1.6 billion, SA banks could potentially classify up to €1.3 billion of loans as fully and completely secured by mortgages on commercial immovable property. For a broader subset of all loans to Latvian residents collateralised by commercial immovable property, there has been very limited growth in recent years. This is markedly different from the period of rapid credit growth in the years leading up to 2007, when the 100% risk weight requirement was originally set, and supports the narrative of the overall improved credit quality of underlying exposures.

Latvijas Banka regularly performs stress tests to assess the ability of credit institutions to withstand adverse macroeconomic developments and unexpected losses. The recent exercise was based on end-2022 data and comprised both a credit risk and a market risk component, including a stress scenario of a 40% haircut applied to CRE as opposed to a 20% haircut in the baseline scenario, among other parameters.[4] The results of the

[4] For more details, see "Financial Stability Report 2023", Latvijas Banka, Riga, August 2023, pp. 39-44.

stress test, in the light of conservative assumptions for both scenarios, demonstrate an overall resilience of credit institutions to withstand economic shocks. Under the stress scenario the losses were estimated at 3.6% of credit institution assets compared with 0.9% under the baseline scenario, with losses from the credit portfolio constituting 45.7% of the total.

The assessment of the risks associated with Latvian CRE exposures by Latvijas Banka is broadly in line with the ESRB assessment, which identified risks from the CRE sector as a source of significant systemic risk in the European Economic Area (EEA) in its December 2022 recommendation and September 2022 general warning.[5] The ESRB recommended EU and national authorities to improve the monitoring of systemic risks stemming from the CRE sector. While acknowledging that the nature of the vulnerabilities varies across EEA countries, the ESRB recommended that, based on the findings from the monitoring, EU and national authorities ensure that financing practices in the sector are sound and financial institutions are resilient. The recommendation was based on an assessment of vulnerabilities identified in the CRE sector that could be a source of risk to financial stability. The findings showed that the sector is vulnerable to cyclical risks related to heightened inflation, a tightening of financial conditions limiting the scope for refinancing existing debt and taking new loans, and the pronounced deterioration in the growth outlook following Russia's invasion of Ukraine. Vulnerabilities related to structural changes include the impact of climate-related economic policies, such as stricter building standards, and the shift towards e-commerce. In addition, the coronavirus (COVID-19) pandemic has accelerated the demand for flexibility in leasable office space as remote and hybrid working models have become more widespread. Furthermore, the ESRB's analysis showed that adverse developments in the CRE sector can have a systemic impact on the financial system and the real economy. Such vulnerabilities can be amplified by spillovers across countries and through interlinkages between financial institutions. Banks are particularly exposed to this sector via credit risk on loans. The ESRB also highlighted these vulnerabilities in its September 2022 general warning, pointing to potential vulnerabilities in CRE markets, among other things.

3. Analysis of the effectiveness and appropriateness of the proposed measure

The purpose of the measure is to mitigate the substantial, albeit decreasing, risks to financial stability associated with CRE exposures. Under Article 124(2) of the CRR, the designated authority has to periodically, and at least annually, assess whether the Article 126 risk weight of 50% for exposures to one or more property segments secured by mortgages on commercial property located in the territory of the Member State of the relevant authority is appropriately based on: (i) the loss experience of exposures secured by immovable property, and (ii) forward-looking immovable property markets developments. The factors are further specified in Commission

[5] See "**Recommendation of the European Systemic Risk Board of 1 December 2022 on vulnerabilities in the commercial real estate sector in the European Economic Area (ESRB/2022/9)**" and "**Warning of the European Systemic Risk Board of 22 September 2022 on vulnerabilities in the Union financial system (ESRB/2022/7)**".

Delegated Regulation (EU) 2023/206.[6] Where, on the basis of the assessment, the authority concludes that the risk weights set out in Article 126 do not adequately reflect the actual risks related to exposures to one or more property segments fully secured by mortgages on commercial immovable property located in the territory of the Member State of the relevant authority, and if it considers that the inadequacy of the risk weights could adversely affect current or future financial stability in its Member State, it may increase the risk weights applicable to those exposures. In the case of the Latvian measure, the increased risk weights reflect the fact that the standard risk weight of 50% is not deemed to be appropriate for CRE exposures based on their loss experience and forward-looking CRE market developments. Given the high share these loans represent in the portfolio of Latvian banks, the inadequacy of the risk weight could adversely affect current or future financial stability in Latvia.

The risk weight measure is assessed as appropriate to address the risks of CRE exposures of SA banks. Lowering the applicable risk weight to 80% reflects the assessment of decreased vulnerabilities affecting CRE exposures compared with the situation in 2007, when a 100% risk weight requirement was implemented. The calibration of the 80% risk weight was also supported by a comparison with IRB banks' implied risk weights, which are on average higher than the 50% risk weight pursuant to Article 126(1) of the CRR and only slightly lower than the newly set 80% risk weight. If there are changes in the relevant loss experience data or the macro-financial environment and its associated risks, the calibration of the risk weight should be reviewed.

The ESRB is of the view that the measure is effective and proportionate. Latvijas Banka considers that since its implementation in 2007, the measure has proved to be effective in ensuring prudent risk management by credit institutions and increased loss absorbency for a subset of exposures in relation to which heightened vulnerabilities have been identified. Other Member States that have experienced comparable commercial property market developments and identified similar vulnerabilities have also set a higher risk weight for immovable property pursuant to Article 126(1) of the CRR. However, in Estonia and Lithuania, the risk weight for exposures secured by mortgages on commercial immovable property remains set at 50%, in line with Article 126(1) of the CRR.

While the measure lowers the loss absorbency requirements for this particular subset of exposures, when viewed together with the gradual implementation of the positive neutral countercyclical capital buffer (CCyB), the overall capital requirements of Latvian banks should not decrease. Currently no other policy instruments are applied that address the same systemic risk; however, a positive neutral CCyB is being implemented in Latvia that will amount to 0.5% by the end of 2024 and to 1% when fully phased-in in June 2025. While the positive neutral CCyB targets a broader scope of credit exposures, both of these measures essentially aim to build up loss-absorbing capacity, which can protect the banking sector from the negative effects of downturns in the property market and/or financial cycle. While the implementation of the positive neutral CCyB helps to increase the resilience of the banking sector in a timely manner against cyclical downturns that may affect a broad

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[6] Commission Delegated Regulation (EU) 2023/206 of 5 October 2022 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards specifying the types of factors to be considered for the assessment of the appropriateness of risk weights for exposures secured by immovable property and the conditions to be taken into account for the assessment of the appropriateness of minimum loss given default values for exposures secured by immovable property (OJ L 29, 1.2.2023, pp. 1-5).

range of relevant credit exposures, in turn the application of a higher risk weight pursuant to Article 124(2) of the CRR should ensure additional loss absorbency for a targeted subset of exposures where particular vulnerabilities have been identified. While these instruments have slightly different mechanics, they both affect the amount of capital that credit institutions are required to hold. In Latvijas Banka's estimation, for SA banks, lowering the applicable risk weight from 100% to 80% will on average counteract up to half of the effect of increased loss absorbency resulting from the application of a 1% positive neutral CCyB once credit institutions have reclassified relevant exposures. As in the short term only a part of the relevant exposures is expected to be reclassified, the counteracting effect of the risk-weight adjustment will probably be even lower. The cumulative effect of both measures when fully phased-in will be tightening.

Conclusions

The ESRB is of the view that the adjusted level of the risk weight for CRE exposures of SA banks is appropriate and effective in addressing the identified risks. Under the current circumstances, the measure does not entail disproportionate adverse effects on financial stability in Latvia or the EU nor is it expected to form or create an obstacle to the proper functioning of the internal market.

The ESRB encourages Latvijas Banka to monitor and periodically reassess the situation and adjust the risk weights depending on the change in systemic risks. This is even more important in the light of the high amount of uncertainty currently in the macro-financial environment. The ESRB recalls that Latvijas Banka is obliged under Article 124(2) of the CRR to assess periodically, and at least annually, the appropriateness of the risk weights set out in Article 126 of the CRR. If these do not adequately reflect the actual risks related to the exposures, and if it is considered that their inadequacy could adversely affect current or future financial stability in Latvia, the designated authority should consider adjusting them accordingly.